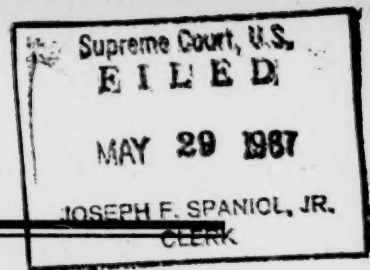


(1)
No. 86-1527



In the Supreme Court of the United States
OCTOBER TERM, 1986

MCCLELLAN REALTY COMPANY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

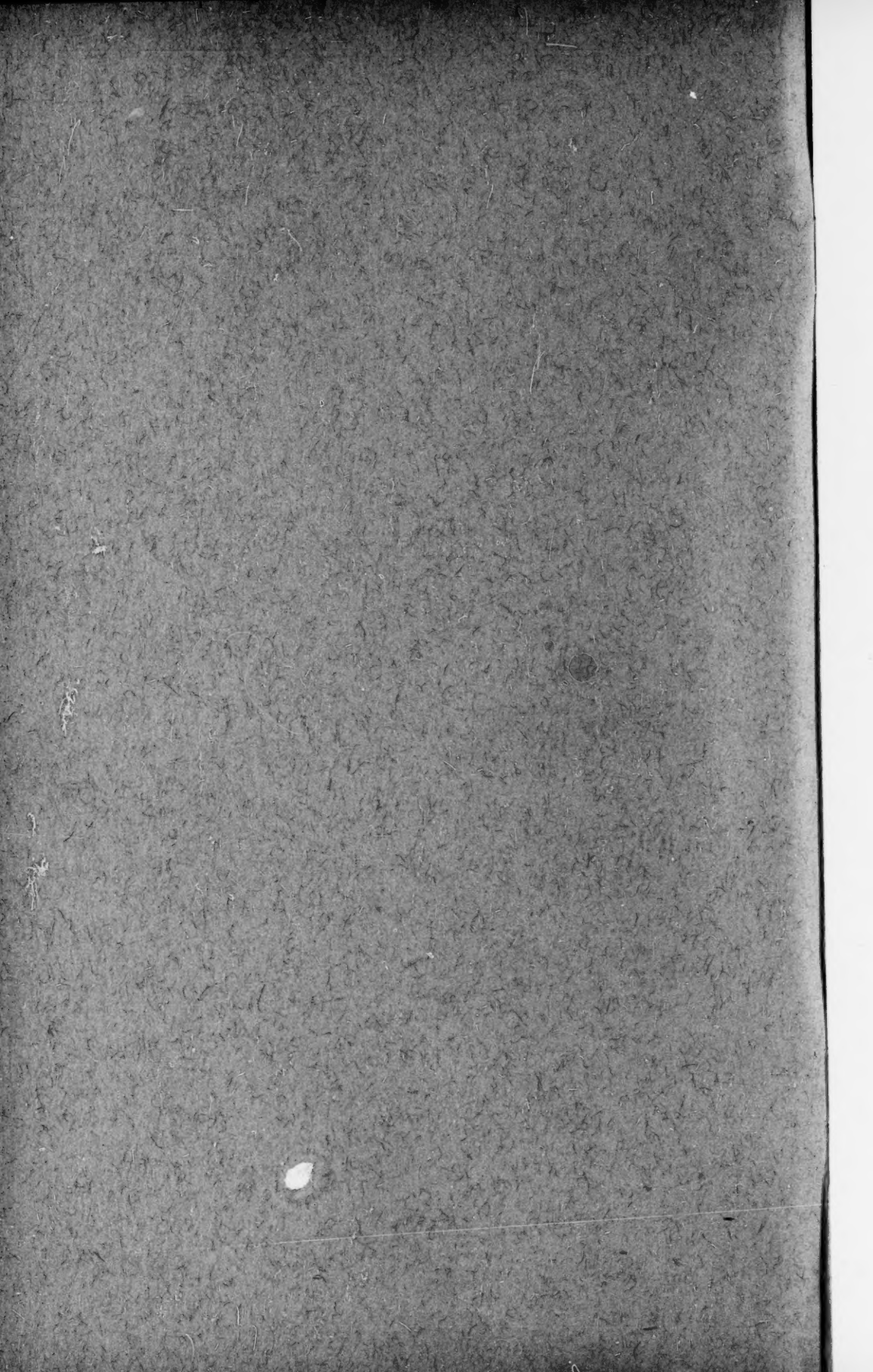
CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

MICHAEL L. PAUP
WILLIAM S. ESTABROOK
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

1392



QUESTION PRESENTED

Whether the leveraged buyout in this case was invalid under the provisions of the Pennsylvania Uniform Fraudulent Conveyance Act, Pa. Stat. Ann. tit. 39, §§ 351 *et seq.* (Purdon 1954).



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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. E) is reported at 803 F.2d 1288. The three separate opinions of the district court (Pet. App. A, B, C) are reported at 565 F. Supp. 556, 571 F. Supp. 935, and 584 F. Supp. 671, respectively.

JURISDICTION

The judgment of the court of appeals was entered on October 22, 1986. A petition for rehearing was denied on November 24, 1986 (Pet. App. F). The

petition for a writ of certiorari was filed on February 20, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Raymond Colliery Co. was a Pennsylvania corporation engaged in the anthracite coal business. Raymond Colliery's holdings consisted primarily of the stock of other companies (the Raymond companies or Raymond group) engaged in the mining and sale of coal, together with real estate and other tangible assets, in Northeastern Pennsylvania. Beginning in 1966 and continuing through 1973, Raymond Colliery experienced severe financial difficulties. During this period, the company was frequently delinquent in paying real estate taxes, federal taxes, and trade accounts. For the year ending June 30, 1973, Raymond Colliery reported a net loss of \$2 million. These serious financial problems resulted in a decision by the shareholders to sell Raymond Colliery. Pet. App. A, 37-39; Pet. App. E, 11-12.

On February 2, 1972, the shareholders executed an option to James Durkin, Sr., or his nominee, for the purchase of Raymond Colliery's stock at a price of \$8.5 million; the option was later renewed at a price of \$7.2 million. Durkin encountered considerable difficulty in obtaining financing to purchase Raymond Colliery. To help facilitate the deal, Durkin incorporated a holding company, Great American, and assigned to it his option to purchase Raymond Colliery's stock. Pet. App. E, 12-13.

Ultimately, Great American obtained a loan commitment from Institutional Investors Trust (IIT), and the loan was closed on November 26, 1973. The

borrowers were four of the companies of the Raymond group. They received \$7 million in direct proceeds, and an additional \$1.53 million was placed in escrow as a reserve account for the payment of accruing interest. The loans were repayable by December 31, 1976, at an interest rate of five points over the prime rate, but in no event less than 12.5%. In exchange, each of the borrowing companies created a first lien in favor of the lender on all of their tangible and intangible assets. The loans were guaranteed by all companies in the Raymond group other than the borrowing companies; the guarantor companies created a second lien in favor of the lender on all of their tangible and intangible assets. Pet. App. E, 14.

When the \$7 million in loan proceeds was received, the borrowing companies immediately transferred \$4.085 million to Great American in exchange for an unsecured promissory note with the same interest terms as the IIT loan. Using these funds and some funds obtained from other sources, Great American purchased Raymond Colliery's stock from its stockholders for \$6.2 million in cash, and a \$500,000 note. Of the total purchase price, at least \$4.8 million was obtained by mortgaging Raymond Colliery's assets. Great American also expended \$2.9 million borrowed from others to pay closing costs on the loan and to satisfy an existing \$2.2 million mortgage to Chemical Bank, the payment of which had been imposed by the shareholders as a condition precedent to the purchase of Raymond Colliery's stock. At the time of the sale, Raymond Colliery's debts exceeded \$20 million. Pet. App. E, 14-15.

The financial condition of the Raymond companies continued to deteriorate after the sale. Within two

months of the closing, the deep mining operations were shut down. Within six months of the closing, all strip mining operations were halted, thereby subjecting the companies to liability for breach of contract. Several lawsuits were filed. Finally, on September 15, 1976, IIT notified the Raymond companies that their mortgage notes were in default and on September 29, 1976, IIT confessed judgments against the borrowing companies for the loan balances due. Pet. App. E, 16.

Thereafter, the lender solicited a buyer for the Raymond Colliery mortgages. On January 16, 1977, James Tedesco, representing petitioner Pagnotti Enterprises, purchased the mortgages from the lender for approximately \$4.5 million. At that time, the balance due on the mortgages was \$5.8 million. Pagnotti thereafter assigned the mortgages to petitioner McClellan Realty Co. On February 28, 1978, in a private unadvertised sale, certain lands encumbered as collateral under the mortgages were sold by McClellan to petitioner Loree Associates for \$50,000. Later in the year, McClellan foreclosed on the Raymond Colliery stock, which had been pledged to IIT in 1974 as additional security, and sold it for \$1 at another private unadvertised sale to petitioner Joseph Solfanelli, as trustee for Pagnotti. No appraisals were obtained for either the stock or the collateral sold by petitioner at these sales. Pet. App. E, 16-18.

2. The United States brought this suit in the United States District Court for the Middle District of Pennsylvania to reduce to judgment certain federal tax assessments made against the Raymond group and its owner, Great American. The district court found that the mortgages executed by the

Raymond Colliery group as collateral for the IIT loan were "fraudulent conveyances" under the Pennsylvania Uniform Fraudulent Conveyance Act, Pa. Stat. Ann. tit. 39, §§ 351 *et seq.* (Purdon 1954) (Pet. App. A). The court further held that the assignment of those mortgages to McClellan was also "fraudulent" under the Act because Pagnotti purchased the mortgages with knowledge that they were fraudulent at the outset (Pet. App. B). The district court, however, rejected the government's argument that, pursuant to Pennsylvania law, petitioner's commercially unreasonable disposition of Raymond Colliery's assets and stock at private sales, coupled with petitioner's failure to prove the value of the collateral sold, extinguished its entire claim on the theory that the value of the collateral in such circumstances should be presumed to be equal to the debt (Pet. App. C, 11-12). Hence, the court added McClellan to the list of secured creditors.

3. The court of appeals affirmed in part and reversed in part (Pet. App. E). The court held that the district court was correct in finding the leveraged buyout to be a "fraudulent conveyance" under Pennsylvania law because the lender did not act in "good faith" within the meaning of Pa. Stat. Ann. tit. 39, § 353 (Purdon 1954). The court explained that the lender knew that the exchange would render the borrower, the Raymond group, insolvent and that no member of the group would receive "fair consideration." Pet. App. E, 20-25.

The court of appeals reversed the district court's holding that McClellan should be included as a creditor by virtue of the assignment to it of the mortgages (Pet. App. E, 45-48). The court explained that McClellan had not shown that its disposition of

certain Raymond Colliery assets and stock that had been collateral was "commercially reasonable" under Section 9-504 of the Uniform Commercial Code, 13 Pa. Cons. Stat. Ann. § 9504 (Purdon 1984). Accordingly, a presumption was created, which petitioner failed to rebut, "that the value of the collateral equalled the indebtedness secured, thereby extinguishing the indebtedness'" (Pet. App. E, 46-47, quoting *Savoy v. Beneficial Consumer Discount Co.*, 503 Pa. 74, 78, 468 A.2d 465, 467 (1983)). Hence, as a matter of state law, petitioner's entire claim as a secured creditor was extinguished by its disposition of the collateral.¹

ARGUMENT

Petitioners contend (Pet. 9-30) that the court of appeals erred in finding that the mortgages at issue here were fraudulent conveyances under Pennsylvania law. This contention—which raises solely an issue of state law—does not merit review by this Court. Moreover, the court of appeals' decision is correct,

¹ The court of appeals affirmed the district court on all other issues. On one of these issues, whether McClellan should receive credit for \$2,915,000 used to pay existing debts of the Raymond group, Judge Higginbotham dissented, arguing that these payments were not fraudulent and hence that only the \$4 million transfer to the shareholders and the creation of a \$1.5 million interest reserve should be set aside (Pet. App. E, 48-49; Pet. App. F). The majority held, however, that the entire transaction was fraudulent, noting that the debts paid off with the \$2,915,000 were either debts that had been personally guaranteed by one of Raymond Colliery's shareholders or were closing costs of the loan transaction found to be fraudulent (Pet. App. E, 31-35). The majority also noted that, even if some portion of the IIT mortgages were valid, that portion had been extinguished by the payments that IIT received from the Raymond Group companies, totalling more than \$4.5 million.

turns on the particular facts of this case, and does not conflict with any decision of this Court or of any other court of appeals.

1. At the outset, we note that the resolution of the question presented here is of purely academic interest; it would have no effect on the disposition of the disputed funds. The court of appeals held that McClellan's claims as a secured creditor had been extinguished as a result of its commercially unreasonable disposition of the collateral underlying the mortgages, and McClellan was ordered removed from the list of secured creditors. Petitioners do not challenge that holding. Accordingly, even if the holding below invalidating the mortgages as fraudulent conveyances were to be reversed by this Court, petitioners would still have no claim as secured creditors. Such a reversal would mean only that petitioners *once* had a larger secured claim than that recognized by the court of appeals, but it does not alter the fact that, *at this time*, their entire claim as secured creditors, regardless of its magnitude, has been extinguished by operation of U.C.C. Section 9-504. Because resolution of the question presented here would have no effect on the ultimate controversy in this case, review by this Court is not appropriate.

2. In any event, the court of appeals correctly concluded that the mortgages were invalid under the Pennsylvania Uniform Fraudulent Conveyance Act. Section 354 of the Act, Pa. Stat. Ann. tit. 39 (Purdon 1954), provides that a conveyance made by a person "who is or will be thereby rendered insolvent, is fraudulent as to creditors, without regard to his actual intent, if the conveyance is made * * * without a fair consideration." Section 353 defines "fair consideration" as an exchange of "a fair equivalent * * * in good faith." Because IIT was aware that the ex-

change would render the Raymond group insolvent and that no member of that group would receive fair consideration, the courts below correctly concluded that this statutory standard was not met and therefore that the mortgages had to be set aside as fraudulent conveyances. See Pet. App. E, 23.

Petitioners attempt to paint this factbound issue as broader than it actually is. Petitioners argue (Pet. 13-21) that the court of appeals erred in "collapsing" the transaction to include consideration of the transfer of the borrowed funds to Great American, suggesting that the court of appeals has established some sort of general rule for the examination of leveraged buyout transactions. But the court here in no way purported to establish a general rule for collapsing transactions; it merely found that, on the facts of this case, there was essentially a single transaction.

The district court specifically found that the funds necessary to accomplish the shareholder buyout were "merely passed through the borrowers to Great American and ultimately to the selling stockholders and cannot be deemed consideration received by the borrowing companies" (Pet. App. A, 53). The court of appeals held that this finding was amply supported by the record, and it affirmed the finding as not clearly erroneous. The record showed that it was shareholder James Durkin, not the nominal borrower, Raymond Colliery, that approached IIT regarding the loan, and the closing was once aborted because of the lender's concern regarding Durkin's partners in Great American. And, of course, the funds were transferred from Raymond Colliery to Great American as soon as they were received. In these circumstances, the courts' analysis of the lever-

aged buyout as one unified transaction clearly was justified. Indeed, the court of appeals specifically noted that petitioners' "arguments against general application of the [Fraudulent Conveyance] Act to leveraged buy-outs are not without some force" (Pet. App. E, 24); it concluded, however, that "the circumstances of this case justify application" (*ibid.*). Thus, it is apparent that the decision below represents no more than the correct application of state law to a particular factual situation.²

Petitioners also challenge (Pet. 22-28) the holding below that the entire transaction should be invalidated, arguing that the creditors' recovery should be reduced by the amount of the settlement paid by the shareholders and by the \$2.9 million of the loan not directly transferred from Raymond Colliery to Great American. As the lower courts found (see Pet. App. E, 30-31), however, the settlement between the cred-

² Petitioners err in contending (Pet. 16-19) that the decision below conflicts with *In re Greenbrook Carpet*, 722 F.2d 659 (11th Cir. 1984). *Greenbrook* involved the question whether there had been "fair consideration" for an exchange within the meaning of Section 548(a) (2) of the Bankruptcy Code (11 U.S.C. (Supp. III)). The district court there had found that there was a "fair equivalent" for the exchange, and the court of appeals, there as here, upheld the lower court's finding on the particular facts as not clearly erroneous. Moreover, the cases involve dissimilar factual situations. The lender in *Greenbrook* was not shown to have lent money to a corporation for the purpose of effecting a leveraged shareholder buyout that would immediately render the borrower insolvent. And the lender in *Greenbrook* was not fully aware of the precise plans that the borrower had for the loan; the lower court specifically found that the lender was not aware that the shareholders in that case would not be personally liable on the subsequent loan to them by the borrower (see 722 F.2d at 660).

itors and Raymond Colliery's shareholders was tailored specifically to satisfy the broad creditor claims that lay exclusively against the shareholders. Clearly, petitioners are not entitled to benefit from this settlement. And the court of appeals correctly rejected the contention that the \$2.9 million used by Raymond Colliery to pay off the Chemical Bank mortgage and the closing costs on the IIT loan should be set off against the creditors' recovery. These payments did not benefit Raymond Colliery's creditors. Most of the \$2.9 million was used either to pay off an indebtedness guaranteed by the intended beneficiaries of the fraud, Raymond Colliery's shareholders, or to pay the closing costs of the loan found to be fraudulent. Hence, the court correctly held that the entire transaction was fraudulent and void as to creditors. See Pet. App. E, 31-35; *Newman v. First National Bank*, 76 F.2d 347, 350-351 (3d Cir. 1935).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

MICHAEL L. PAUP
WILLIAM S. ESTABROOK
Attorneys

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